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UBIT: What Associations Need to Know

Although trade and professional associations are granted a general exemption from federal income tax by the Internal Revenue Code (Code) – for income from activities that are substantially related to the purposes for which the association's tax-exempt status was recognized by the Internal Revenue Service (IRS) – they nevertheless are potentially taxable for income derived from unrelated business activities. The Code defines an unrelated trade or business as "any trade or business the conduct of which is not substantially related (aside from the need of such organization for income . . .) to the exercise or performance by such organization of its . . . purpose or function constituting the basis for its exemption . . ."

The tax on unrelated business income first appeared in the Code in 1950. Congress' principal purpose in enacting the unrelated business income tax (UBIT) was to provide a level competitive playing field for tax-paying business – so that tax-exempt organizations could not use their privileged tax status to unfairly compete with tax-paying businesses in activities unrelated to their purposes. But instead of prohibiting tax-exempt organizations from engaging in any business activities at all (and denying or revoking tax exemption because of such activities) – which it had considered doing – it chose to specifically permit a certain degree of business activity by tax-exempt organizations, but to tax it like any other for-profit business. Thus, such business activities are permissible, so long as the activities are not a "substantial part of its activities." The tax applies to virtually all tax-exempt organizations, including associations and their related foundations.

The most common form of unrelated business income for associations, by far, is advertising income (e.g., in periodicals, on websites, on social media, and the like).

The imposition of the unrelated business income tax is generally at the federal corporate income tax rate (now a flat 21% rate, following the 2017 federal tax reform legislation). Deductions are permitted for expenses that are "directly connected" with the carrying on of the unrelated trade or business, and net operating losses are allowed to be carried forward and backward (with certain limitation). Following the 2017 federal tax legislation, losses from one unrelated business activity are no longer able to offset gains in another (profits and losses are determined per activity).

Three-prong UBIT test. It is important to note that not all business income is subject to taxation or to limitations: only "unrelated business income" as defined in the Code. Unrelated business income will only exist if three conditions are satisfied; if any one of the three is not present, then income from the activity will not be taxable. The income must be:

1. from a trade or business;
2. that is regularly carried on; and
3. that is not substantially related to the purposes which form the basis of the organization's tax-exempt status.

Exclusions. Even if all three conditions of the UBIT test are satisfied, there are numerous statutory exclusions (i) from the definition of an unrelated trade or business, and (ii) in the computation of UBTI, which can exempt otherwise taxable income from UBIT. Many such exclusions are potentially applicable to trade and professional associations and their related foundations, while many are not. The most relevant exclusions tend to include:

- Qualified corporate sponsorship payments
- Royalties
- Qualified convention or trade show income
- Interest, dividends, annuities, and certain capital gains
- Certain non-debt-financed rental income from real property
- Volunteer labor exception
- Sale of donated goods
- Certain research income

Taxable subsidiaries. If the gross revenue, net income, and/or staff time devoted to unrelated business activities become "substantial" in relation to the tax-exempt functions of an association (thereby jeopardizing its tax-exempt status), the association can "spin-off" one or more of the unrelated activities into a separate but affiliated, wholly owned entity, commonly referred to as a taxable subsidiary. Such a taxable subsidiary will pay corporate income tax on its net income, but can remit the after-tax profits to the parent association as tax-free dividends; however, the dividends are not tax-deductible to the taxable subsidiary as business expenses.

Filing and payment requirements. In computing UBTI, a specific deduction of $1,000 is permitted. If an association has gross UBTI of $1,000 or more during its fiscal year, it must file a completed IRS Form 990-T to report such income and pay any tax due. The Form 990-T is due at the same time as the Form 990, however, if an association expects its annual UBIT (after certain adjustments) to be $500 or more, then it must make estimated tax payments throughout the year. The Form 990-T is *not* subject to public disclosure like the Form 990.

For more information, contact Mr. Tenenbaum at jeff.tenenbaum@lbkmlaw.com.